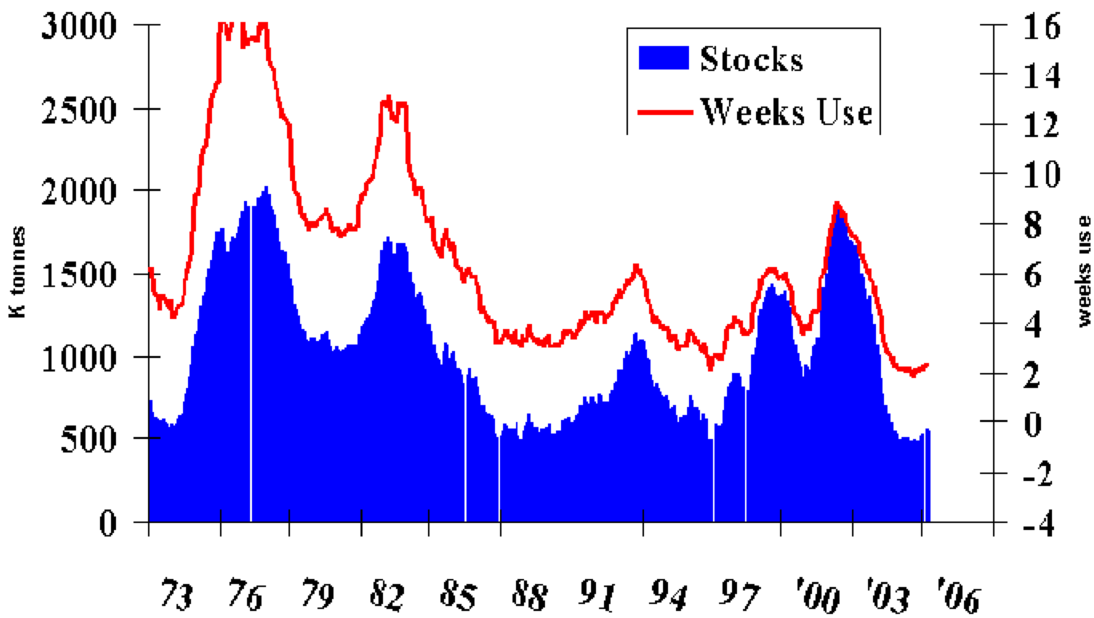
Man Financial

Do Fundamentals Matter Anymore? **May 2006**

Forecasting metal prices used to involve assessing basic supply and demand fundamentals. To a large extent, this is still true, but the spectacular price rallies of the past year begs the question of just how relevant fundamentals have become given the enormous amount of "fund money" flooding the markets. This brief will look at where metal prices have historically been as measured by a key fundamental ratio, and where prices are today based on this same measure. It will also examine the scope and size of fund money that is currently in the system.

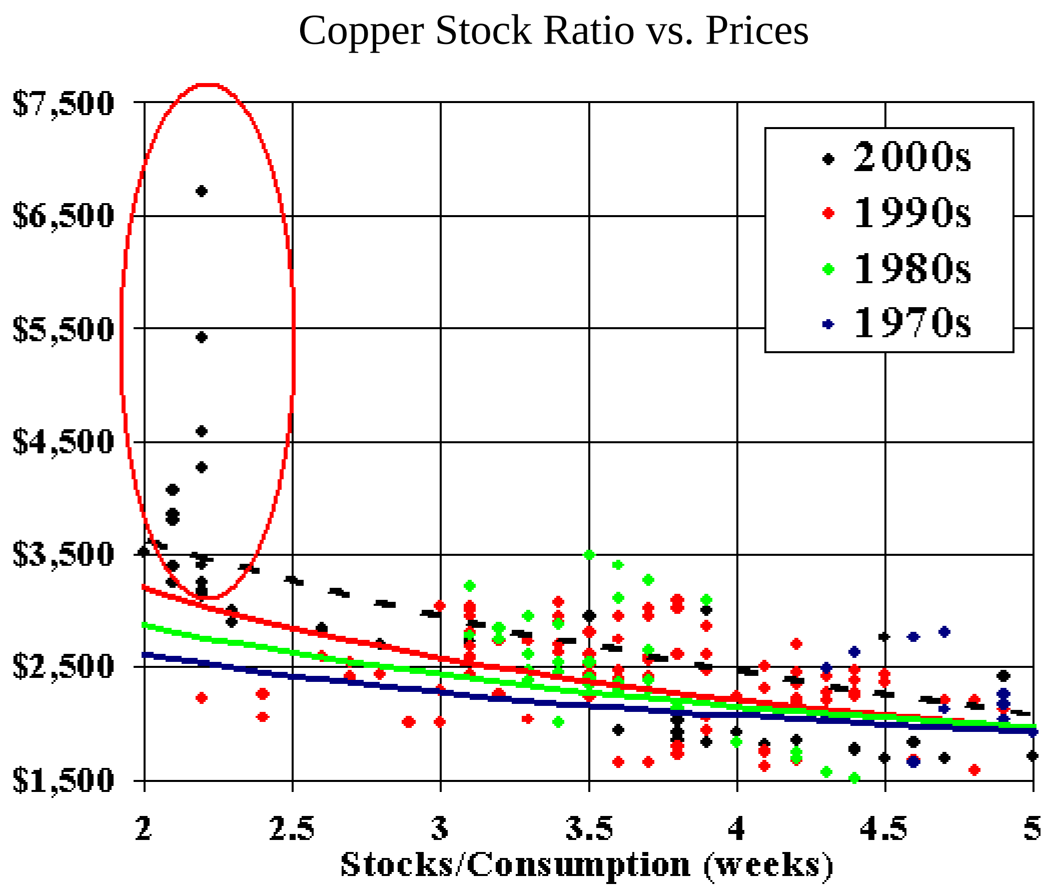
The stock to consumption ratio is a widely used fundamental measure used to forecast metal prices, and basically tells us how many weeks of global weekly inventory there is given the current rate of consumption. We note from our graph below, for example, that in copper's case, the current stock ratio (in red) is about 2 weeks. This is very similar to levels in reached 1997, 1988, and 1974.

Copper Price vs. Stocks/Consumption Ratio

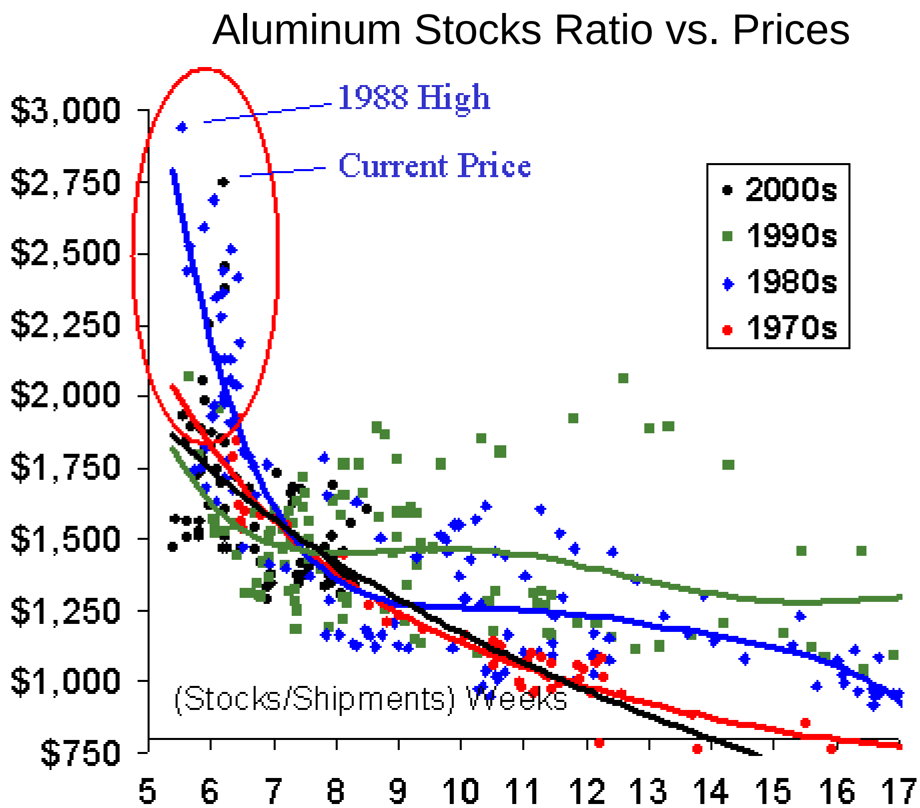


Yet, if we plot this ratio against monthly average prices, as we do in the following chart, we see just how much *higher* copper prices are this time around compared to previous cycles. The circled area in red shows the cluster of monthly average prices in the past year when the stock ratio was at 2-2.5 weeks. We note that prices in this decade were in the $3,000-$6,700 range, with the spike to $6,700, of course, occurring just this month. Now look at where average prices were in the 1970's, 1980's and 1990's when the stock ratio was at similar levels -- prices never breached the $3,500 in any of the periods under question*.

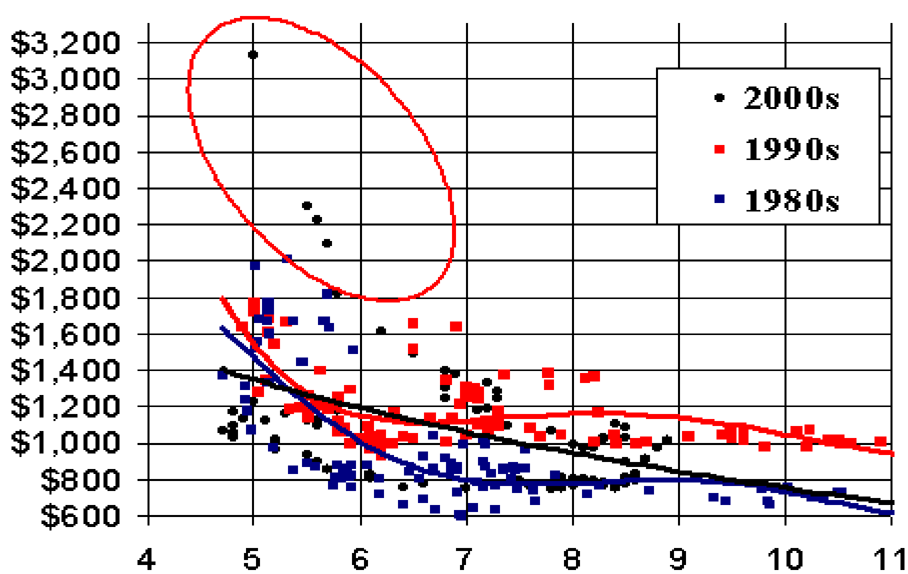
* The recent price spikes are not as high when adjusted for inflation. However, making such "inflation adjustments" is in itself debatable given that the cost of producing most metals has fallen over the years.



Our stock ratio for aluminum (chart, next page) shows the same thing, namely, that price spikes were much higher over the past two years than they were during other periods when the stock ratio was low. We note that the current stock ratio is around 6 weeks, with prices averaging $2750 so far this month. The only other time when prices responded with a similar spike was in the 1980's when a low ratio took prices briefly to just below $3,000 on a monthly average basis. On the other hand, when the ratio was similarly low in the 1970's, prices barely got to the $2000 level.



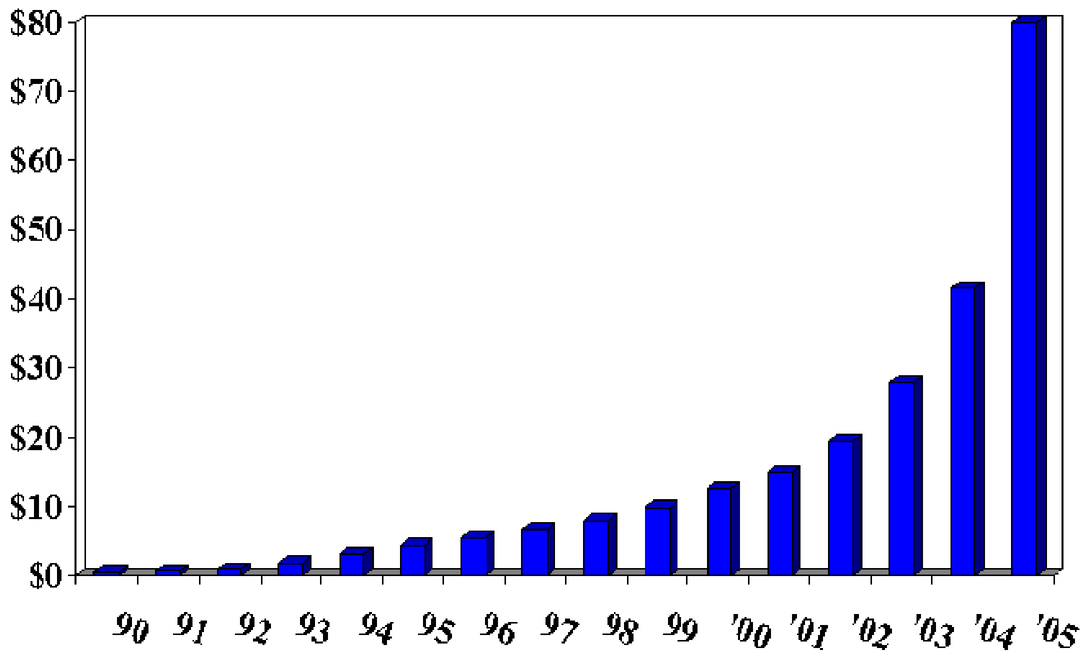
In the case of zinc, we see in the chart below that there has been a similar push higher lately, with the market now looking at 5-6 weeks of global inventories on hand. In fact, price spikes this year are almost *double* levels reached in the 1980's when the stock ratio was at a similarly low level.



The charts above suggest that funds are responsible for the recent exaggerated price swings in these metals, as fundamentals alone– at least by this one key measure – do not fully explain the explosive moves higher.

The types of funds at work in our markets are both the active kind, (commodity trading advisors and hedge funds), as well as the passive kind (index funds). Data we have compiled shows just how quickly all three groups have grown in terms of money under management. Index funds have $80 billion under management, (chart 1) and primarily seek commodity exposure through various “fixed baskets” in order to negatively correlate (and reduce) existing risk on existing bond and stock portfolios. The second group -- the CTA’s -- have $130 billion under management (chart 2), while global hedge funds have an estimated $1,000 billion under management. (Depending on their charters, some of the funds in the global hedge fund group are also allowed to trade commodities).

Index Funds (in billions) (Chart 1)



Source: Man Financial Estimates

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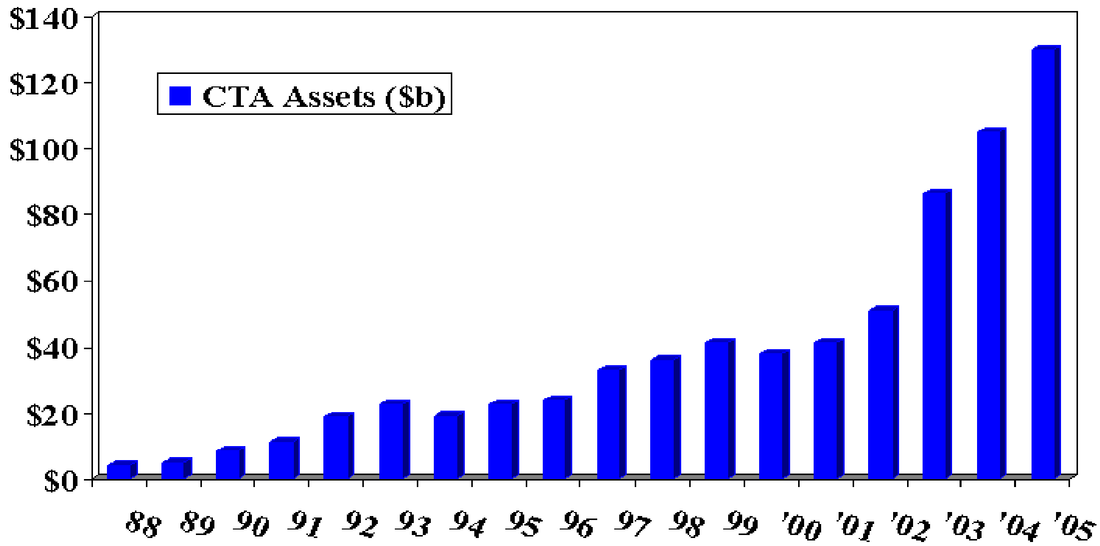
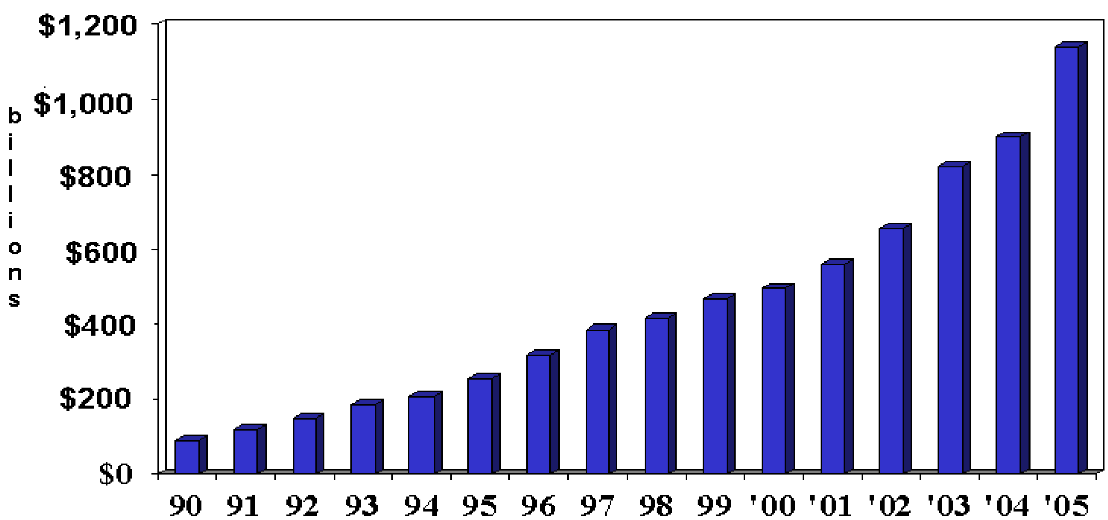
CTA Funds (chart 2)

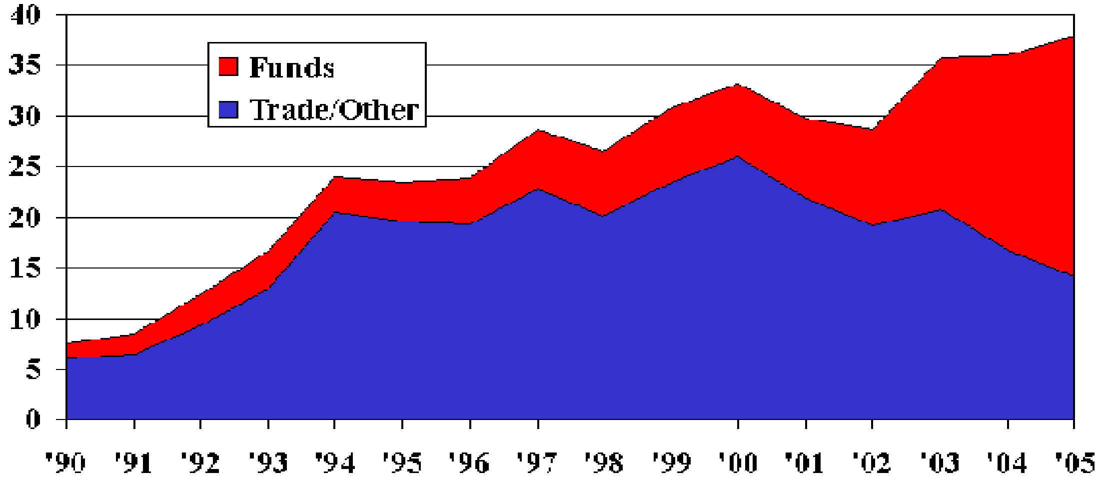


Global Hedge Funds (chart 3)



Source for Charts: Man Financial

One of the symptoms of growing fund involvement in the markets is that fund volume has outpaced that associated with "trade origins". We note from the graph on the next page that LME fund volume (in red) has exploded of late, while volume by commercial origins has receded mainly due to the fact that holding short positions in raging bull markets consumes an enormous amount of cash flow and becomes a difficult endeavor to sustain.

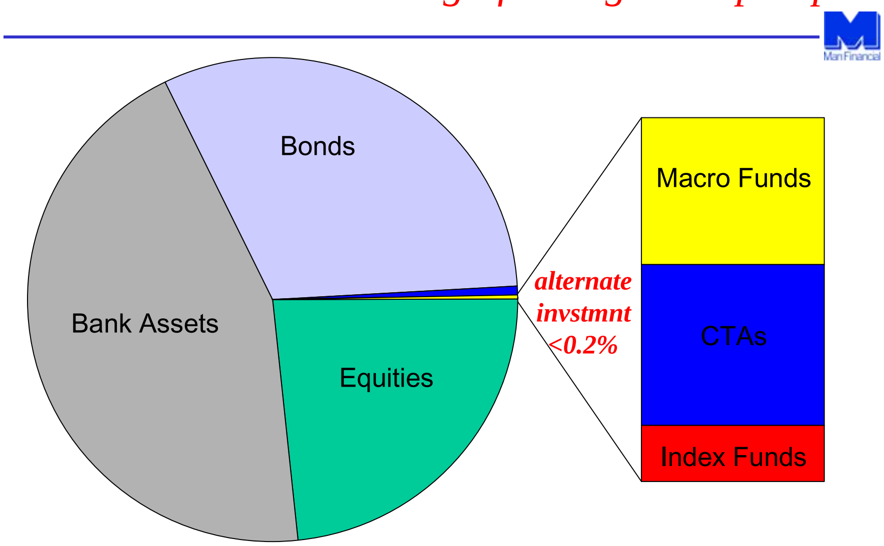


Source for Data: Man Financial

What is striking when looking at the role of funds, is just how much *more* money potentially exists that could still enter the commodity markets. The chart below captures this point. Here, we show total investable funds in the world – a whopping $150 trillion. Of this amount, roughly half is held by banks, a little more than a quarter is in bonds, and a little less than a quarter is in stocks. However, look at the category of alternative investments where macro funds, CTA's, and index funds reside. This group *currently* comprises a mere 0.2% of total investment funds, suggesting that there is still much more room to grow.

Global Investments, *$150 trillion*

alternative investments: significant growth prospects



Source for Charts: Man Financial

Conclusions:

We predict that commodity markets will continue to attract even more fund money, especially given the current investment mindset where commodities are very much "in vogue". So are fundamentals still relevant, or shall we all attempt to start tracking fund flows instead? Our view is that over the long run, fundamentals *are* relevant, but because their impact period is so long, funds will dominate short-term trading and direction. We also find that funds usually *reinforce* the price direction set by the prevailing fundamentals, but do a poor job fighting the underlying trend as previous, largely contrarian, commodity debacles have illustrated.

Commodity analysts, among others, will therefore have to come to terms with funds as an ongoing and growing presence in the markets. Short-term indicators, like technical patterns, volume, open interest, and "commitment of trader reports", (classifying the types of investors have open positions), will all have to be utilized more frequently to get a better sense of what funds are doing.

Commercial hedgers have to counter the increased intraday volatility by making more use of options. They also have to move away from fixed-price hedging and towards premium hedging in order to avoid being caught in raging bull (or bear) markets whose intensity is frequently whipped up by fund activity.

The exchanges themselves have to make information available more quickly so investors get a better sense of fund flows. As an example, the frequency of commitment of trader reports could be increased to a daily basis as opposed to the current weekly snapshot. After all, measuring how long or short funds are these days is perhaps just as important as knowing about the next mine strike.

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